A MOTLEY FOOL SPECIAL REPORT

HOW TO KNOW WHEN TO SELL

The Motley Fool
To Educate, Amuse & Enrich™
How to Know When to Sell

Brought to you by David and Tom Gardner, Co-founders, The Motley Fool

Knowing when to sell is a crucial yet overlooked aspect of investing. Snagging shares at a bargain can mean absolutely nothing if you don’t sell when you should. Sadly, we can’t give you “The Immutable Laws of Selling.” We heartily agree with Philip Fisher, who said, “If the job has been correctly done when a common stock is purchased, the time to sell it is — almost never.” That’s why we target a three-year holding period for each of our recommendations. Will all stocks last three years? No. There are some things to consider and some general situations when selling might be a good idea. And believe us, an exit strategy that works for you not only makes you a more comfortable investor but also helps you beat the market.

How to Know When to Sell

Price Performance vs. Fundamentals

We’ve long held that the decision to sell should be driven more by fundamentals and valuation than stock price performance. It seems natural to want to lock in gains or to cut our losses, but rarely will those instincts in and of themselves make a sound case for selling.

It’s much better to focus on the fundamentals and the reasons we bought a stock in the first place. Odd as it sounds, the fact that Netflix (Nasdaq: NFLX) jumped 100% or Costco (Nasdaq: COST) dropped 20% wasn’t sufficient to make us want to sell either stock, and both have risen since those milestones.

But that’s us. What’s right for you depends on your own particular investing style and tolerance for risk. Maybe you love highflying, risky companies, and their volatility doesn’t bother you. Or maybe you are risk-averse, and any significant gain or loss keeps you up at night watching your hair turn gray. Most likely you’re somewhere in the middle.

David especially is a strong proponent of letting his winners run. For you, holding a stock with a big gain (yes, you must define “big” for yourself) may simply be too stressful. If you absolutely dread losing some of those gains, take some money off the table. David won’t hold it against you. You could even sell it all, but remember, this can also cause stress. You might just regret letting go of a company you like, know, and believe in.

Or maybe it’s not the unrealized gain that bothers you so much but that your portfolio is suddenly overweight with a Netflix or an Amazon.com (Nasdaq: AMZN). Maybe, like David, you still like both businesses, but you’re happy with your gains, and locking some in makes you feel more balanced. By all means, go for it.

By the same token, you might be stressing over Costco’s decline, finding yourself snapping at Buster for lapping water onto the floor (can’t that dog use a straw?!), and generally miserable that Costco’s ticker is flashing red instead of green. Again, sell (the stock, not the dog).

Finally, you might be fully invested, but, like Tom, you really like another stock, such as Coventry Health Care (NYSE: CVH). If so, redeploying resources might make sense. The opportunity cost of missing out on new gains may justify selling a current holding. That can be a sound market-beating strategy. Of course, there’s risk in selling one company to buy another, just as there’s risk in holding what you already have.

If it seems like a cop-out for us to be saying this, we’ll remind you that in the end, portfolio management is personal. Investing shouldn’t ruin your life. If it does, you’re not doing it right, no matter what stocks you pick. Sell, and rethink your strategy and appropriate risk level.

But please, please, please don’t be the person who sells a stock at $10 with plans to rebuy it if it falls to $9. Maybe that works for somebody, somewhere, but we doubt it. We’re investors, not traders.

Two Simple Reasons to Sell

So far, we’ve said nothing about company fundamentals. There are, however, some very distinct, company-specific scenarios that almost always justify selling.

1. If a company’s CEO resigns abruptly for no apparent reason, that almost always means trouble.

Pay attention to the words “almost always.” A CEO could leave and be replaced by a turnaround specialist. In this case, we might make an exception to the departing-CEO rule. Usually, though, the rapid departure of a CEO is a bad sign.
2. A major shift in the business's focus also signals problems ahead.

By “major,” we mean a situation where a company completely changes its business model or strategy, essentially implying that its previous model was a failure, or will be very soon. When Office Supplies Inc. turns into Astronauts R Us, just get out and be glad you did.

Fundamental Reasons to Sell

More often than not, knowing when to sell requires that you monitor a company’s fundamentals — its operations and prospects for growth. The vast majority of your sell decisions will be of this type, though even this is a question of style.

Tom, as you’ve gathered, watches the financials like a hawk. After all, his picks are based on detailed assumptions. Tom’s a patient man, but if a company fails to deliver — say, on cash flow growth — he will think hard about selling.

David is more forgiving, more focused on the franchise than the relationship between the financials and stock price. But there are certain red flags that neither of us dares ignore.

Slowing sales growth for companies in hot sectors may signal a good time to sell. All hot sectors cool off eventually, and getting out ahead of the slowdown isn’t a bad strategy. After two quarters of slowing year-over-year sales growth, consider selling.

Divergent sales and profit growth represent another good time to sell. If sales are climbing at 70% and profit growth suddenly drops below previous levels, then it’s “Danger, Will Robinson.” A rapidly changing business environment can cream a company, and is the result. Don’t stick around hoping things will get better. Sell.

Plummeting cash flow is another sign of trouble. While earnings might look rosy, cash flow is crucial to a company’s health. If earnings are there but cash flow isn’t, look out below. As soon as you uncover this scary situation, sell.

Last But Not Least...

A business that is deteriorating should be sold. Of course, we can’t foresee every possible reason that would cause us to turn on our recommendations, but we are ready and watching. And should we spot trouble, you’ll be the first to know.

Don’t Look Now!

Once you’ve sold a stock, don’t obsess about how it’s doing. We’ve seen too many people rue their sale a mere day or week later when it rises above their out price. “See, Gladys? I should’ve held on. Lookie there, it just crossed $46!” “No,” we say to these sellers, “don’t look now!” The best way to review your selling decisions is to let some time pass.

We don’t think you should check the price of a stock you sell until three months later. When you check, note the stock’s percentage gain or loss. Then compare that with the S&P 500’s gain or loss over that very same period. We’re always reminding Foolish investors to stay focused on how the market has done rather than just how your own stocks have done. If you only know how your stocks have done, you’re quoting the story out of context!

As you’ve probably gathered, selling is in many ways more art than science. It’s an art you have to master in order to be a great investor. Our goal is to help you become Monets and Rembrandts. We discourage you from ever thinking about selling as a fearful, isolated predicament that you must face with your stocks. We like to think of selling as a prelude to smart buying — a necessary step as you improve your portfolio.

David owns shares of Amazon.com and Netflix. The Motley Fool owns shares of Costco.